CAPITALIZATION OF PERIODICAL PAYMENTS BY GIFT

A CERTAIN cartoon of 1804 reveals John Bull, rotund, ruddy, and perplexed, scratching his head over a long scroll entitled "A Plain Short and easy description of the Different Clauses in the INCOME·TAX," which shows nothing more than a tangle of cross references. Near the upper right-hand corner of the picture hovers the younger Pitt, equipped with wings and a harp, in the capacity of "Guardian Angell." The "Angell" radiates good cheer and confidence. If Pitt has since 1913 occupied a point of vantage commanding a bird's-eye view of the United States, he must as an expert have extracted vast amusement from this country's frantic efforts to learn in half a dozen years as much about income taxation as Great Britain has learned in over a hundred.

The States render our task more difficult by overlaying the federal tax, no joke in itself, with a patchwork quilt of local levies on income. We have had plenty of income taxes in the past. They began as early as the seventeenth century.[1] But these old-time levies were generally failures, and were either wiped off the statute books or disregarded in practice. They produced comparatively few judicial precedents, and we face the new crop of resolutely enforced, successful income taxes with little knowledge as to the manner in which the courts will treat them. Under present conditions, the analysis of questions relating to taxation is neither academic nor dry.

I

THE PROBLEM

In particular, the differentiation of "statutory" or taxable income from other kinds of wealth presents an extended field for controversy of lively practical importance. Training and viewpoint sometimes lead the enthusiastic tax collector to claim that all receipts from any source are income.[2] The most signal contra-

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[1] See list in KENNAN, INCOME TAXATION, 210 *et seq.*

[2] Doyle *v.* Mitchell Brothers Co., 247 U. S. 179 (1918); Southern Pacific Co. *v.* Lowe, 247 U. S. 330, 335 (1918).

diction of this claim is found in the well-established rule as to gifts.[3] Under the English statute,

"Pure acts of grace and favour, the outcome of goodness of heart, perhaps done at times of rejoicing, should not be taxed." [4]

And

"A voluntary gift, *e. g.*, an allowance by a father to his son, would not be assessable." [5]

A ruling of the Massachusetts commissioner of corporations and taxations exempts gifts.[6] Wisconsin seems a little more doubtful, if we may judge from a case where an attempt to tax as income an inheritance of foreign land was given fairly serious consideration, receiving its *coup de grace* through close interpretation of the statute rather than through an appeal to general principles.[7] This, however, is not enough to shake the rule, particularly in view of the explicit provision of the federal revenue act that "gross income" does not include

"The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income)." [8]

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[3] When gifts are spoken of herein, real gifts are meant, and not so-called gifts or bonuses which are actually a kind of compensation for services. The distinction sometimes becomes a very fine one. See numerous British cases as to what is and what is not taxable income of a clergyman. Blakiston *v.* Cooper, [1909] A. C. 104, is a fair sample. See also U. S. TREAS. REGS. 45, arts. 32, 107, 108; MASS. RULES AND REGS. 5008, 5014, 5016, 5017, 6032, and 6035. The Massachusetts Rules and Regulations referred to here and elsewhere are those promulgated in January, 1920, by the Commissioner of Corporations and Taxation; the United States Treasury Regulations 45 were revised as of December 2, 1919, and to the date of writing have not been substantially modified with respect to the subject matter of this article.

[4] T. HALLETT FRY ON INCOME TAX, 110. And see Cooke *v.* Fry, 3 Tax Cas. 335, 341 (1895); Drummond *v.* Collins, [1914] 2 K. B. 643.

[5] MURRAY AND CARTER, GUIDE TO INCOME-TAX PRACTICE, 5 ed., 97.

[6] MASS. RULES AND REGS. 4002.

[7] State *ex rel.* Brenk *v.* Widule, 161 Wis. 396, 154 N. W. 696 (1916).

[8] Revenue Act of 1918 (Act Feb. 24, 1919, c. 18, 40 STAT. AT L. 1065), § 213, subsec. (b), (3). The New York statute is practically identical. N. Y. LAWS, 1919, c. 627, § 359–2 (c). In United States *v.* Oregon-Washington R. & Nav. Co., 251 Fed. 211, 214 (1918), Ward, C. J., handed down a dissenting opinion in the course of which he said: "The Income Tax Laws of 1913, 1916, and 1917 expressly provide that only the income of gifts is to be taxed, from which it may be inferred, that but for this provision, the gifts themselves would have been taxed as income." Such may be the learned judge's inference, but it is not mine. These laws give the impression of pushing the power of taxation to its limits rather than of voluntarily restricting it.

The quoted passage has double significance. It gives statutory sanction to a time-honored practice. It also shows that the topic of this discussion is by no means contemptibly narrow. Here the specific problem paradoxically includes the broader general one, for if we are forced to distinguish between the principal and the income of a gift, we must formulate and bring to bear rules applicable to the income tax in its largest aspects. When doing this, it will be a help rather than a hindrance to confine the immediate application of those rules to narrow and concrete questions.

Even standing alone, the discussion would be well worth while, because gifts have acquired undeniable business importance. The "science of giving" receives nowadays the most earnest and prayerful attention. We prescribe the courses in which our estates shall flow when we die, and it is increasingly common, not only for wealthy persons but also for those more modestly classified as well-to-do, to divide much property during life. This tendency has two obvious causes.

First, the "cost of dying," as measured by inheritance and estate taxes, has assumed alarming proportions.[9]

Second, the punishing federal surtax makes the concentration of income very bad business indeed. The easiest way to "spread" income is by outright gift of the property from which it springs. But expediency has led to the adoption of certain other legal devices which fall short of such gifts and still depart radically from the old-fashioned voluntary allowance to a child or other dependent. One of these furnishes a convenient thread on which to string the present discussion. Suppose we have a wealthy father who for one reason or another does not desire to give his dependent daughter any large amount of principal. If he sticks to the scheme of doling out five hundred or a thousand dollars a year for pin-money, there is no doubt that the daughter will escape income tax, but an equal certainty that the father will gain nothing except the warmth of her gratitude. He would like the right to make a deduction from his gross income. He therefore gives her a ten- or twenty-thousand dollar promissory note bearing five per cent interest. She makes no promises about not calling for the principal, yet considerations

[9] 4 MASS. L. QUART. (No. 3), 157 and 5 *id.* (No. 2), 107 contain discussion of the tax on gifts in contemplation of death. It is doubtful whether this tax can or should be made to cover any large fraction of the class of gifts *inter vivos*.

of policy are almost certain to prevent her from doing so against her father's wishes. The father is entitled to claim tax deductions on account of his interest payments. Waiving any question of personal exemption, the daughter is now in receipt of a taxable income. It is better, though, for her to pay tax at a low rate than for her father to pay at a high rate. Between them, they economize by making each dollar go further. Still, both parties would be pleased by a refinement of this plan, under which the donor remained tax free and the donee had fuller advantage of the rule exempting gifts.

Undoubtedly such refinements will be, or are being, attempted. What form can they take, and how far are they likely to succeed?

II

Single Payments

For the sake of thorough analysis we should examine a gift of income involving only a single payment before proceeding to the complications introduced by periodicity of payment.

Suppose that our donor — and for convenience let us call him D — owns on January 1, 1920, a thousand-dollar six per cent bond, originally bought by him at par. Attached to the bond is one bearer coupon for sixty dollars. Both bond and coupon are payable December 31, 1920. There is no doubt as to the solvency of the obligor. The market rate of interest is and remains six per cent. D tears off the coupon on New Year's day and gives it to our recipient, whom we will call R. In due course D receives his thousand dollars and R receives sixty dollars when he cashes the coupon. Where and how deep can income tax strike?

Take R first. Must he in 1921 return for tax the whole sixty dollars; or none of it; or the amount by which the coupon appreciated during his ownership? Of these three positions, the first seems unsound. The argument to sustain it is that the exemption of gifts applies only to things in possession, not to *choses in action;* that the paper and ink of which the coupon was made cannot be taxed, but that the promised payment giving it real value is fully assessable. The difficulty with this in the particular case is that we are discussing a *chose in action* which has been thoroughly "chattelized." People buy and sell and variously deal with cou-

pons every day. Coupons are considered an embodiment, not a mere symbol, of value. But the same argument can be put much more broadly. It is a far cry indeed to the time when a promise to pay money, even if not embodied in a specialty, was deemed a personal, unmarketable right. The all-pervading promissory characteristics of modern business have compelled acceptance of the view that such legally enforceable promises are merchantable property. It would be flouting everyday commercial practice to hold that the exemption does not include this kind of property.

The second position, which presents the rosiest countenance to the taxpayer, is at least arguable. It must be admitted that while the coupon was part of the parent bond it had no independent commercial identity or capital value; but it can be asserted consistently with this admission that severance of the coupon accomplished its emancipation and set it up in independent business with a capital status and value of its own.[10] Accession to this value caused by approach of the day when the bond interest is payable means simply more capital, and not income at all. Some jurisdictions have held that such accession of value, even when translated into money by sale, is not taxable income unless it arises in the regular course of the recipient's business.[11] But this line of reasoning suggests an embarrassment. Suppose D follows up his gift of the coupon a day or two later by giving R the scalped bond also. Unless the taxing authorities can prove that the two acts were preconceived as parts of a scheme to cheat the public revenues by pretending to split a single gift, it would seem that R owes no tax even after realizing on both coupon and bond. Yet we know that he would have been taxable for the full value of the former if it and the bond had been given him still joined together.

On the whole, the third position appears soundest. It is in accord with the tendency manifested under recent American income-tax acts to assess increases of capital value. Whatever the general merits of that practice, its application here hardly produces an unjust result. For an analogy, consider the case of a discounted

[10] A good instance of the half-dependent, half-independent nature of coupons is found in Kenosha *v.* Lamson, 9 Wall. (U. S.) 477 (1870); s. c., annotated, 19 L. Ed. 725.

[11] See British text-writers and numerous British cases. For instance, Tebrau (Johore) Rubber Syndicate, Ltd. *v.* Farmer, 5 Tax. Cas. 658 (1910); s. c., 47 Sc. L. R. 816 (1910).

promissory note. The amount of the discount is held to be income.[12] Any other holding would permit wholesale avoidance of tax.

Accepting the third position, we can under the hypothetical facts calculate R's tax in advance:

Present value of coupon when received $\times$ 1.06 = \$60
Present value of coupon when received = \$56.60 +
Income received when coupon cashed = \$3.40 −

Turn now to D. The gift itself brought him no material gain. Back of any donation may lie a feeling of duty or of family affection, or the tremendous spiritual significance of the widow's mite and Sir Launfal's bowl of cold water. These things are beyond temporal taxation. But D ultimately exchanges his bond for its face value in cash. The natural view would be that this exactly balances his original investment and produces no taxable income. Still, an astute tax collector may incline to argue the point. One proposition which the collector will *not* urge is that D's original thousand-dollar investment flowed all through the bond and the coupons and sought a common level, as water does in a lake; that whenever D cashed a coupon he received in exchange a payment representing some income and some principal; that therefore the final payment on redemption of the bond contained a certain amount of income. The government disables itself to make this claim by taxing *all* the interest as fast as it comes in, thus asserting that every cent paid against coupons is income and the last thousand dollars only is repayment of principal.

A similar but somewhat stronger argument is that the coupon was capitalized in D's own hands during the act of gift, and sucked fifty-six dollars and sixty cents worth of capital out of the bond while it was being torn off. Thus the bond, apparently calling for a payment of principal only, really came to call for a mixed payment of which an indistinguishable fraction worth fifty-six dollars and sixty cents was income and taxable as such. But *Hartman* v. *Greenhow*,[13] which lawyers will remember as one of the landmarks along the weary road trodden by Virginia's creditors after the Civil War, seems likely to block this contention.

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[12] U. S. TREAS. REGS. 45, art. 34; MASS. RULES AND REGS. 2006, 2007.
[13] 102 U. S. 672 (1881).

There the Commonwealth of Virginia had issued bonds, agreeing that the coupons should be receivable at face value in payment of taxes. After the issue, a law was passed providing for taxation of the bonds and deduction of the tax from interest payments. The plaintiff, owning coupons cut from bonds belonging to a stranger to the litigation, presented his coupons in payment of some state tax. The defendant, a collector of state taxes, refused to receive them without making the deduction which the tax law purported to authorize. The plaintiff applied for mandamus. A divided court denied the application. On error the United States Supreme Court, one justice dissenting, reversed this ruling. The decision went only upon the ground that Virginia had tried to impair the obligation of contract. But any State which tumbles into that bramble bush will find that

> "There's a great text in Galatians
> Once you trip on it, entails
> Twenty-nine distinct damnations
> One sure, if another fails."

Constitutional prohibitions fairly focus on acts of this kind. Thus the following passage from the majority opinion:

"Here, also, the coupons held by the petitioner were distinct contracts imposing separate obligations upon the state. He was not the owner of the bonds to which they had been originally attached. In his hands they were as free and discharged from all liability on those bonds as though they had never been connected with them. And surely it is not necessary to argue that an act which requires the holder of one contract to pay the taxes levied upon another contract held by a stranger cannot be sustained. Such an act is not a legitimate exercise of the taxing power: it undertakes to impose upon one the burden which should fall, if at all, upon another." [14]

These words are trumpet-tongued with the deep damnation of the Fourteenth Amendment. They voice an absolute prohibition without hint of compromise by apportioning the tax. If it was wrong to assess Hartman for taxes on account of principal, it would seem equally wrong to assess D for taxes relating to interest which he has in the plainest way turned over to R.

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[14] 102 U. S. 684–685. And see New York, etc. R. R. *v.* Pennsylvania, 153 U. S. 628, 645–648 (1894).

It may be suggested that payment to D's nominee is the same as payment to D himself. Take, for example, *Rensselaer & S. R. Co.* v. *Irwin.*[15] Here the X railroad had leased its line practically in perpetuity to the Y railroad, the latter covenanting to pay four per cent semiannual dividends directly to the former's stockholders. Although the dividend money never came into the possession of the lessor company, it was held under the act of 1913 to constitute taxable income of the lessor.

But this is very different from the hypothetical case under consideration. X owed its stockholders a duty to use its assets for their financial benefit. Every time Y paid and the stockholders accepted a dividend, X's obligation was for the moment satisfied. Potential causes of action against X were extinguished. An orderly, prearranged series of such extinguishments is just as much income as an orderly, prearranged series of cash payments. Our friend D differs from X because D's generosity brings him nothing in any form having a material value.

If the conclusions stated or indicated up to this point are correct, it appears that a single instalment of future income can be severed from its capital source and given away in such manner as to free the donor from all income tax in respect thereof, and at the same time subject the donee to only a very moderate tax.

III

Periodical Payments

Can periodical payments be capitalized in the same manner? Putting aside legal rules, undoubted persuasiveness lies in the claim that all periodical receipts, as distinguished from isolated single receipts, are income. It is hard to say in a word why this is so, but the reason will be brought out as we go along. The taxpayer counters the claim by saying that at most it expresses a presumption, rebuttable on proof that any particular series of receipts under consideration has the effect of exhausting the recipient's capital.

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[15] 239 Fed. 739 (1917); s. c., *affd.* C. C. A., 249 Fed. 726 (1918). The statement of facts by the majority of the upper court is not clear. It half gives the impression that X was also taxed upon amounts which Y paid directly to X's bondholders as interest on their investment. Such action would of course make a ridiculous circle, for X by applying this additional income to the payment of interest gets a claim of deduction exactly offsetting these receipts.

But the law does not march entirely in step with either of these propositions. We know well enough that receipts produced from such a wasting subject matter as a mine may be income.[16] To take the other side, no one would have the temerity to claim that a legacy becomes income simply because it is payable by instalments, half at the end of the first and half at the end of the second year after the testator's death.[17] Between these instances lies a wide stretch of debatable territory. In mapping this out, it will be well to deal first with the British and then with the American law.

(a) *The British Law*

Parliament's legislative power is so nearly unrestrained that the principal question with respect to the scope of British tax laws is one of intrepretation. Since 1842 at least the form of the income-tax statutes has been such as to give even interpretation little play in designating the property on which these laws operate. Not satisfied with any general phrase like "net income," the various "schedules" refer to specific things such as "annual value" of lands, "gains," "profits," "annuities," "yearly interest" of money, and "annual payments." However, English judges and jurists employ their sound common-law training to prevent harsh or unjust construction of statutes. A very interesting series of cases distinguish from the thing taxable as an "annuity" certain other things closely resembling it and sometimes loosely called annuities themselves.

The series opened in 1858 with *Foley* v. *Fletcher*,[18] where it was alleged that the plaintiff had sold mining property at a named price to the defendants, who promised to pay the price in semi-annual instalments running over some thirty years. When the defendants began deducting income tax from the periodical payments, the plaintiff sued and was met by a plea setting forth the purpose of the deductions. The case came up on demurrer to this plea. The court had to and did admit that annuities were expressly taxable, but felt strongly that Parliament had not intended to

[16] Stevens *v.* Hudson's Bay Co., 101 L. T. (N. S.) 96, 97 (1909); and several cases in the United States Supreme Court, of which Von Baumbach *v.* Sargent Land Co., 242 U. S. 503, 520, 524 (1917), is typical.

[17] This illustration given in Foley *v.* Fletcher, 3 H. & N. 769, 785 (1858).

[18] *Ibid.*, 769.

levy an assessment on capital. Being of opinion that the instalments in question were capital, the judges addressed themselves to formulating a definition of "annuity" through the meshes of which payments under this contract could squirm their way to exemption. The task was not easy. Pollock, C. B., said:

"this is not a contract to pay an annuity, but to pay a principal sum of money, and the court can only carry into effect the language of the act." [19]

And Baron Watson added:

"an annuity means where an income is purchased with a sum of money, and the capital has gone and has ceased to exist, the principal having been converted into an annuity." [20]

That is, the parties showed they had in mind the payment of a definitely specified principal sum. Seemingly the plaintiff, far from treating as expendable income the periodical payments, would heap them up to replace the capital asset for which they were the equivalent. So the plaintiff had judgment.

The point was clinched about half a century later by *Secretary of State in Council for India* v. *Scoble*,[21] which went to the House of Lords. The facts were approximately parallel to *Foley* v. *Fletcher* except that the series of instalments was called an "annuity" by the contract of purchase and each instalment was defined as including (1) a part payment of principal and (2) interest on unpaid principal. The holding was that no tax could be exacted with respect to that part of each payment designated as (1).

About two years afterwards an unsuccessful attempt was made to distinguish a third case of the same general nature on the grounds that the total price to be paid was not clearly ascertained, and that the plaintiff had gone out of its way to expedite the exchange of its capital asset (a railway) for a series of periodical payments.[22]

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[19] Foley *v.* Fletcher, 3 H. & N. 779.

[20] *Ibid.*, 784–785.

[21] [1902] 2 K. B. 413, [1903] 1 K. B. 494, [1903] A. C. 299. Commenting editorially on the case, the LAW QUARTERLY REVIEW said, "It lays down, or rather reaffirms, a clear and intelligible principle." 19 L. QUART. REV. 255, 256.

[22] East Indian Railway Co. *v.* Secretary of State in Council for India, [1905] 2 K. B. 413; argument of counsel better reported in 21 T. L. R. 606. Endeavors to press the exemption beyond cases of this type have not been crowned with success. Delage *v.* Nugget Polish Co., Ltd., 92 L. T. (N. S.) 682, and 21 T. L. R. 454 (1905), annual payments for use of secret process; Chadwick *v.* Pearl Life Insurance Co.,

Mr. Walter Strachan has written several articles for the LAW QUARTERLY REVIEW,[23] in the course of which he comments upon and explains the British decisions just noted. What he says is worth careful consideration. For a non-judicial definition of income he turns to an American, Professor Irving Fisher:

"(a) *Capital is a FUND,* (b) *Income is a FLOW. A fund of property existing at an instant of time is called capital. A flow of services rendered by that capital, for instance, by the payment of money from it, or any other benefit rendered by a fund of capital in relation to such fund through a period of time, is called income.*" [24]

The definition draws no distinction at all between the flow proceeding from a jug of known and limited capacity and the flow from a hydrant connected with the city water works. So Mr. Strachan justifies the taxation of a terminable annuity because it is a flow, although consisting "only of a *single jet.*" [25]

But the English courts clearly do not subscribe to this interpretation of Professor Fisher's definition. They have decided that some payments which flow from and exhaust capital funds are themselves capital, not taxable income. They must treat the jug and the hydrant alike so long as the former is the old oaken

[1905] 2 K. B. 507, annual payments in return for assignment of lessees' interest in real property; Jones *v.* Inland Revenue Commissioners, [1920] 1 K. B. 711, 89 L. J. (K. B.) 129, variation of Delage case. Compare Oswald *v.* Kirkcaldy Corporation, [1919] S. C. (Scotland), 147. These cases suggest numerous interesting lines of inquiry which diverge too far from that followed by the text to be pursued here.

[23] "The Differentiation of Capital and Income," 18 L. QUART. REV. 274; "Capital and Income under the Income Tax Acts," 29 *id.*, 163; "Income Tax in Relation to Annuities," 33 *id.*, 172.

[24] Copied from 29 L. QUART. REV. at page 170. Previously given with immaterial variations in punctuation, 26 *id.*, 40.

[25] 29 L. QUART. REV. at page 170. Parliament in the middle of the nineteenth century probably was not so philosophical. When the modern income-tax acts came in, the most common sort of annuity in England was the government consols. These were perpetual, unless the government saw fit to redeem them. Under either contingency no question of a wasting corpus arose. As indicating their financial importance, we find in WILLICH'S POPULAR TABLES, 4 ed. (1859), beginning at page 88, a five-page tabulation showing the price of three per cent "consolidated annuities" for every year from 1731 to 1858; also the average rate of return on these securities; and in addition a running table of historical events which bore upon the price of the annuities. May not these public securities have filled Parliament's vision almost to the exclusion of the very different terminable annuity? An interesting historical summary bearing upon this point is available in Appendix 7 (j) to the first instalment of the minutes of evidence before the Royal Commission on the Income Tax (1919–1920).

bucket or some equally time-honored container which Parliament knew and named in its act. When a plaintiff appears with a new-fangled non-refillable bottle, he is given a careful hearing and sometimes gets back his taxes. "Statutory" income is by no means identical with economic income. Mr. Strachan puts the idea gracefully:

"Economics is a relentless logical science; Law tempers logic with justice and equity, 'Right and wrong, between whose endless jar justice resides.' It may be logical, but it would be unjust to regard purchase-money, or building-society instalments in repayments of a capital advance, as income taxable under the Income Tax Acts, and thus the law stands." [26]

He then presses the point of intention. The man who buys a terminable annuity intends it to be and treats it as an income stream; the owner or creditor who sells a railway or lends money with provisions for instalment payment normally means to retain at least part of each instalment as a capital fund. Plainly this argument of intention must not be allowed to run wild, or the saving, canny Scots of Edinburgh would pay little income tax, but it is useful within proper bounds.[27]

If *Secretary of State* v. *Scoble* had arisen under our own federal income tax act, immediate inquiry would have been directed to the original cost of the railway or its value on the date when the tax became effective. Congress and our treasury officials believe that appreciation of capital assets, when realized by sale, is taxable income. The British, on the contrary, say that such an accession is not income unless it accrues to the taxpayer in the regular course of his business. The owners of mines or railways are in business to operate their properties, not to sell them, and profit on such a sale would probably strike a British court as pure capital gain.

This phase of the discussion seems to have led us far afield from D and R. But the significance of the cases is in their hint that if Parliament had not from the first taxed annuities by name, the

[26] 29 L. QUART. REV. 171.

[27] On the matter of intention, I refer again to WILLICH'S POPULAR TABLES and find, commencing on page 39, a two-page table indicating how much per annum, at several different rates of interest, must be subtracted from the annual payments under a lease, estate, or annuity for a given number of years certain in order to replace the purchase-money or capital. Clearly there are two sides to the intention argument.

judges might have insisted upon dissecting these wasting investments and have dealt with some part thereof as principal. Blackstone, writing about usury well before the birth of the modern British income tax, recognized payments under life annuities as containing (*a*) instalments of principal, (*b*) legal interest, and (*c*) "additional compensation for the extraordinary hazard" due to the uncertainty of human life.[28] Much more recently there has been in England lively discussion concerning the injustice of taxing the whole of an annuity payment. In part this discussion was sidetracked by the proposition that it would be unfair to change the tax laws because many existing contracts had been made with the taxation of annuities allowed for by the parties.[29] English courts turn a tolerably indulgent ear to the pleas of those receiving annuity-like payments arising in novel manners. To bring this down to the very case of our donor and recipient, suppose D in England tore a dozen successive coupons off a bond and gave them to R. The latter's lawyers would very likely not be laughed at if they claimed that up to the value of the coupons at the time of gift, any receipts from them remained capital, despite the fact that these receipts came to R in a stream flowing through several years.

(b) *The American Law*

For reasons which will soon appear, it is now necessary to subdivide the discussion as follows:

(1) *Terminable Annuities.* By annuity I mean the strict annuity, which Coke defines as a

> "yearly payment of a certaine summe of monèy, granted to another in fee for life or yeares, charging the person of the grantor onely." [30]

(2) *Terminable Rights to the Income of Property held in Trust.* I purposely avoid considering the taxability of receipts derived from property to which the recipient has a terminable legal title and right of possession. This line of discussion would too greatly expand the present article.

(3) *Terminable Charges upon Property.* It is assumed that the

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[28] BL. COMM., bk. II, p. 461.

[29] MURRAY AND CARTER, GUIDE TO INCOME-TAX PROCEDURE, 5 ed., 265. See also the last reference in note 25, *supra*.

[30] CO. LITT. 144 b.

property is in the possession of some person other than the individual entitled to the benefit of the charge.

(1) *Terminable Annuities*

From what has already happened, it seems safe to say that the United States will shelter a score of assorted income-tax systems before many years pass. Without wandering too far among the mazes of local law, we may, for the sake of contrast if for no other reason, examine the practical application of the present federal and Massachusetts statutes in respect of annuities. Almost the only point of similarity between the two acts is that each was made practicable by a constitutional amendment. The federal law imposes a general tax upon income at progressive rates; Massachusetts imposes three or four different special taxes at rates non-progressive but varying according to the income sources, and leaves much income altogether untaxed.[31] Looking beyond mere differences in the statutes themselves, we find them standing against wholly different historical backgrounds. For many years before 1913 the federal government had lived principally on the proceeds of highly indirect taxes. Hence the United States income levies have blazed their own trails. But Massachusetts has since the seventeenth century operated a direct general property tax, important parts of which survive side by side with the new income tax substituted for certain sections of the older law. The sturdy veteran is sure to influence, and not unlikely to overshadow, the young shoot grafted upon it.

Few or no federal cases deal squarely with the taxability of annuities as income. There are some analogous decisions about mines and the like, but it is unlikely that these would be deemed entirely decisive of the annuity question.

Does "income" as used in the Sixteenth Amendment include the entire receipts from an annuity? Since the definition of the term

[31] MASS. GEN. ACTS, 1916, c. 269, taxes only income received by residents. Income from stocks, bonds, notes, money at interest, and the like, is taxed at six per cent; income from annuities at one and one-half per cent; income from professions and businesses at one and one-half per cent; and net gains from sales and purchases of intangible personalty at three per cent. The rates have been increased, largely because of war expenses. There are numerous exceptions and deductions not here material. Massachusetts has a very complicated and entirely distinct corporate income tax.

must come not only from etymological derivation but from "the implicit assumptions of its [the word's] use in common speech," [32] the English practice at the time of the amendment's adoption is germane. No doubt many members of Congress and of our state legislatures knew that England taxed annuities as income and had done so for at least seventy years. But it is equally just to assume that they knew of the doubts about and protests against this action and of the fact that one reason given for its continuance was "let well enough alone." Having regard for all these facts, the legislators by mere failure to define "income" as used in the amendment can hardly have meant to incorporate the somewhat peculiar British usages. Actual practice supports this view. The treasury and the federal courts have broken with English traditions, notably in the taxation of casual capital profits.[33]

In 1913 it would have been useless to turn to America herself for any general "implicit assumption" respecting the taxability of annuities as "income." Certain states had settled opinions based on the application of local tax statutes, but the country at large had been too little concerned with this kind of problem to possess a real national opinion as to its proper solution.

The existing federal law on its face is an illogical compromise. "Gross income" does not include the amount received by an annuitant "as a return of premium or premiums paid *by him*" under an annuity contract.[34] The revenue officials obviously must refrain from taxing receipts under annuities purchased with the annuitants' own money until the aggregate of such receipts exceeds the aggregate premiums or consideration paid.[35] But they might have held a donated annuity fully taxable. Such holding seemed to be indicated by a ruling with respect to testamentary charges.[36] A later, although less authoritative, statement is to

[32] See opinion by Learned Hand, D. J., in United States *v.* Oregon-Washington R. & Nav. Co., 251 Fed. 211, 212–213 (1918).

[33] And the federal income-tax authorities at least do not tax a man on the annual value of a house owned by him and occupied as his residence. See Brushaber *v.* Union Pacific Railroad Co., 240 U. S. 1, 23 (1916). The British law does impose this kind of tax. HALLETT FRY ON INCOME TAX, 61.

[34] Revenue Act of 1918, 40 STAT. AT L. 1065, § 213, sub.-sec. (b), (2).

[35] U. S. TREAS. REGS. 45, arts. 47, 72.

[36] "An annuity charged upon devised land is income taxable to the annuitant, whether paid by the devisee out of the rents of the land or from other sources." U. S. TREAS. REGS. 45, art. 47.

the effect that an annuity purchased for R by D is not taxable until the payments thereunder equal the amount paid or set aside to purchase or establish the annuity. Income Tax Ruling No. 289. *Quære* whether this extends to testamentary annuities. It ought to, in logic and common sense. For if D by will gives R an annuity, the latter may demand payment of the present capital value in a lump.[37] Doing this, R could make and pay for his own annuity bargain with an insurance company. Possibly, under the law of some jurisdictions, a capable draftsman would be able to concoct a will preventing such action, much as ordinary restraints on anticipation are contrived. But this should make no difference. Every one of the cases suggested presents substantially the same problem of wasting capital.

It is worth noting in this connection that the Scoble case is probably sound federal law. The treasury has issued several rulings which recognize the existence of principal in periodical payments on instalment purchases.[38]

Now for Massachusetts. Here the income-tax statute specifically designates the "income of annuities" as assessable.[39] But this begs the question beautifully. It is our immediate problem to find what *is* the income of an annuity. We encounter forthwith a long sweep of historical background. In the old days Massachusetts tax acts were passed annually or at least with considerable frequency. They fell into conventional form, each following its predecessor closely in the designation of taxable property. Eighty-odd years ago the case of *Swett* v. *Boston*[40] decided that a testamentary annuitant was not taxable under one of these acts providing for the assessment of the "capital or principal sum" of a trust fund. While this case was pending, its probable outcome was foreseen, although the legislature at least missed the point that a true annuity does not issue from any defined fund of capital. Late

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[37] Parker *v.* Cobe, 208 Mass. 260, 94 N. E. 476 (1911); Matter of Cole, 219 N. Y. 435, 438, 114 N. E. 785 (1916); *In re* Robbins (Robbins *v.* Legge), [1907] 2 Ch. 8.

[38] U. S. TREAS. REGS. 45, arts. 42, 44, 45.

[39] MASS. GEN. ACTS, 1916, c. 269, § 5 (a).

[40] 18 Pick. (Mass.) 123 (1836). Compare the extraordinary case of Kennard *v.* Manchester, 68 N. H. 61, 36 Atl. 553 (1894), where grasping assessors, having taxed certain land to the tenant under a fifty-year lease, tried to tax the rent by capitalizing it at eight per cent and thus assessing the lessor for $100,000 "money on hand, at interest, or on deposit."

in 1835 the Revised Statutes were passed, continuing an old levy on professional and business incomes and adding thereto a new one on the

". . . income . . . from an annuity, unless the capital of such annuity shall be taxed in this state." [41]

The wording of this section changed only slightly down to 1916, when the modern income tax appeared.

It will be noted that this provision of the old general property tax also begged the question at issue, for it was laid on the "income" of annuities without any specification as to what that income was. The practice was to tax the whole of every receipt. There is a curious lack of reported cases about the assessment of annuities under the general property levy. Only rarely and casually have the courts referred to this particular part of the statute. The truth is that while there may have been a theoretical practice of taxing every payment in full, it came to be a practice actually more honored in the breach than in the observance. Mr. Henry H. Bond, former income tax deputy, speaking of the old tax on professional and business income, — it was, by the way, far from oppressive, — says it "had become little more than a tax in theory, yielding but little revenue, enforced against few taxable persons;" and he tars the associated annuity tax with the same brush.[42]

If the Massachusetts courts had ever been pushed to the wall, there is no reason to doubt that they could have held the former levy on annuities to be a valid property tax; could have said that when it spoke of income it meant money at rest in the pocket of the annuitant and not income flowing from obligor to obligee.[43] *Loring* v. *Beverly* [44] is an analogous case. Here a trustee on tax day had in bank money received as dividends on non-taxable stock. The deposit was assessed as property. In sustaining the assessment, the court distinguished income from property taxes by saying that the latter impinge on property upon the tax day; the former cover "all property received as income during the tax year." This is inaccurate. The Massachusetts judges even now call their income levy a "property tax" and in the case of income

[41] MASS. REV. STAT., c. 7, § 4; compare the COMMRS. REP., c. 7, § 4.
[42] PROCEEDINGS NATIONAL TAX ASSOCIATION, 1917, 92–93.
[43] Opinion of the Justices, 220 Mass. 613, 618, 624, 108 N. E. 570 (1915).
[44] 222 Mass. 331, 110 N. E. 974 (1916).

from investments are undecided as to whether the tax is imposed on the principal of the investments or on the income as received.[45] If a state wishes, it can have a tax day every week,[46] or even a sort of continuous "blue Monday." [47] The real question is whether income is taxed as a *flow* or as a *thing*. Granted that an annuity is taxed as a thing, and granted also that the legislature has undoubted power to tax all property, whether income or capital, within its jurisdiction, misdescription of the mixed fund as "income" alone is not fatal or even serious. All that has to be decided is that the legislature duly expressed the intention "whatever it is, it is taxed." The history of events in 1835 reveals beyond a reasonable doubt the existence and expression of such an intention.

It follows that the long-continued Massachusetts description of receipts from annuities as pure income *need* not be given much weight. More than that, the Massachusetts legislature has expressly recognized and taken advantage of the fact that annuities have a capital value. Move the much-travelled D and R to Boston, let D die, and let him leave a testamentary annuity to R. Can the state consistently capitalize that gift for the purpose of exacting legacy tax — which it does [48] — and then claim that for the purpose of the income tax there is no capital value? Any attempt to justify this on the ground that the taxes are "of a different nature" is wide open to demurrer.[49] True, but what of it? Freedom from income tax is not claimed because succession duty has been paid, but because when calculating the amount of this duty

[45] Maguire *v.* Tax Commissioner, 230 Mass. 503, 512, 120 N. E. 162 (1918).

[46] Commonwealth *v.* Brown, 91 Va. 762, 21 S. E. 357 (1895).

[47] Opinion of the Justices, 77 N. H. 611, 615, 93 Atl. 311 (1915).

[48] MASS. ACTS, 1909, c. 490, pt. IV, § 6. Wisconsin exempted from income tax "all inheritances . . . which are subject to and have complied with the inheritance tax laws of this state." A testamentary annuitant whose annuity had been capitalized and assessed for inheritance tax claimed that the installments were not taxable income. *Held*, that the contention was sound. State *ex rel.* Kempsmith *v.* Widule, 161 Wis. 389, 392, 154 N. W. 695 (1915). But the trust income out of which the annuity was paid was taxable to the trustees. State *ex rel.* Hickox *v.* Widule, 166 Wis. 113, 163 N. W. 648 (1917). In the second case the court split hopelessly, and some justices wished to retract the first decision. Compare the ruling under the federal income tax of the Civil War days. SELIGMAN ON THE INCOME TAX (ed. 1914), 470.

[49] Part of the court in State *ex rel.* Hickox *v.* Widule, 166 Wis. 113, 123, 163 N. W. 648 (1917), thought such justification good.

the government has advanced and relied on the notion that the string of future payments can be capitalized in the present. A more truly logical way out of the dilemma lies in asserting that so applied a succession tax is nothing more than a sort of supplemental, anticipatory income tax. This line of argument has been familiar in England since 1853, when Gladstone suggested that the death duties effected a differentiation of income tax rates in favor of earned income. It would be more of a novelty in the United States.

But notwithstanding all this, one can scarcely doubt that if the present application of the Massachusetts income tax to annuities were challenged, the government would be victorious. For one thing, the challenger would not cut a very appealing figure. The rate of tax on a pure annuity is less than one-quarter the rate of tax on income from most intangible property.[50] Besides, tax acts survive an extraordinary number of logical blows. Here the judges would say that the definition of "income" in the amendment to the Massachusetts constitution depended far less on dictionaries, logic, and economics than on established fiscal usages.[51] What matter that the law of 1836 had broken down? It stood on the books for more than three-quarters of a century. Every lawyer, most of the legislators, and a goodly proportion of the voters knew about it. They must have meant to include in their amendment the kind of thing which had for so long been called income.

Thus the status of annuities under the federal revenue act is uncertain; under the Massachusetts law they have little chance of escape. But under both laws it is probable that many periodical payments will be split into income and principal and only partially taxed, or even called pure principal and not taxed at all. It would be dangerous to say that we shall swing further than the British in this direction, for the situation here is complicated by our habit of taxing accessions to capital value. Still R with his dozen gift coupons severed from the bond could make a lively and hopeful battle.

Some general observations upon the annuity matter will not be a

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[50] For the original rates, see note 31, *supra*. Rates on business income and on income from stocks, bonds, and the like, increased by GEN. ACTS, 1919, c. 324 and c. 342. *Quaere* if the low rate on income from annuities is an unscientific recognition of their perishable nature.

[51] Tax Commissioner *v.* Putnam, 227 Mass. 522, 526, 528, 116 N. E. 904 (1917).

waste of time, for no doubt the various American states can produce situations running all the way between that of the federal government with its lack of tradition and that of Massachusetts with her overload of tradition.

The Massachusetts commissioner of corporations and taxation has made two very significant rulings.[52] He supposes a corporation granting a pension to an employee. If the pension can be stopped at any time in the corporation's pleasure, the payments are gifts and not taxable as realization of an annuity. If the employee has a right to compel continuance of the pension irrespective of the corporation's desire, a taxable annuity is created. Observe that this difference cannot be because in the latter case a right of action springs into being. Creation or transfer of a right of action is thoroughly consistent with a gift. The courts will protect rights properly passed by gift, just as they will protect other rights.[53]

The fundamental distinction between these cases lies in the fact that under the second only did the corporation create a dependable expectation of continued benefit. That pensioner could rely on his pension; the first pensioner could not. The average man would be quick to recognize three kinds of gifts. To begin with, a donation to meet a special emergency — illness, some unusual liability, or any of a thousand accidents of life. Although such a donation may be by instalment, it will not spread over any great stretch of time and the donee will not distinguish it in effect from a single, unified act of generosity. It comes, it goes, and is not to be counted on for the future. It is not taxable income. Then we may have a piecemeal payment clearly intended for saving rather than for immediate consumption. A fair example is a large legacy payable in fractions. This is not income at all. Nine times out of ten it will be saved or, if expended, used to discharge capital obligations.

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[52] MASS. RULES AND REGS. 5016 and 5017.

[53] Illustrations are legion. We need not seek beyond the decisions of Massachusetts herself. A legatee may sue the executor; a donee of a bearer bond may sue the obligor, a third party; a sealed guaranty is binding even though executed gratuitously, Roth *v.* Adams, 185 Mass. 341, 70 N. E. 445 (1904); the donee of an unindorsed promissory note may collect from the maker, a third party, Grover *v.* Grover, 24 Pick. (Mass.) 261 (1837); the donee of an unindorsed stock certificate can compel the donor's personal representative to perfect the gift, Herbert *v.* Simson, 220 Mass. 480, 108 N. E. 65 (1915). Compare Kennedy *v.* Howell, 20 Conn. 349 (1850), and St. Paul's Episcopal Church *v.* Fields, 81 Conn. 670, 72 Atl. 145 (1909).

Last comes a series of payments of such size and spread over so long a time that the man who receives them will consider them permanently recurrent additions to the fluid wealth wherewith he discharges current expenses. They become one of the enduring elements which go toward fixing his standard of annual outgo. If the recipient thus ignores or forgets the element of obsolescence with respect to the payments, why is not the tax collector entitled to do likewise? The perfect example is a life annuity. But the term may well be certain and at the same time shorter than the average expectation of life. I have heard a sagacious man of affairs say that for him "fifteen years was eternity." He knew from experience how utterly all prospects might alter in a fifteen-year period, and felt that it was vain to try regulating the more distant future. One could hardly deride a court for holding that a line of regular payments running somewhere between ten and fifteen years was so extended as to occupy the position of income in the recipient's scheme of existence.

The statement of these distinctions is by no means intended as a surrender to them or a guaranty of their legal effect. In practical argument they may not hold water at all. But they cannot safely be disregarded.

(2) *Terminable Rights to the Income of Property Held in Trust*

Probably five trusts out of six are composed principally of intangible personal property. The old common law did not recognize life estates in personalty, but ultimately a distinction was drawn between the use and the ownership. Colloquially speaking, however, the *cestui* has no "use" of the trust property. He rarely even sees it. His "life estate" or other interest carries not possession but a right to net income. The customary words of limitation are a direction to the trustees to pay the income to So-and-So for such-and-such a time, although the same result follows where this particular formula is not used.[54] If the *cestui* sold his interest, the purchaser would fix the price by estimating as nearly as might be the present value of the future payments.

So far, then, as questions of mere marketability are concerned, this kind of gift is very like a terminable annuity. But although we have observed a certain reluctance to tax as income the pro-

[54] Field *v.* Hitchcock, 17 Pick. (Mass.) 182, 183 (1836).

ceeds of an annuity, no similar feeling has been manifested with respect to the periodical proceeds of a trust fund. This unbending attitude of the taxing power does not pass unchallenged, as appears from the Notes on the Revenue Act of 1918 submitted by the Secretary of the Treasury to the House Committee on Ways and Means in November, 1919. While the submission was "without recommendation at this time," the material no doubt had received careful consideration. The Notes suggest legislation which will definitely prevent life tenants of trusts from claiming obsolescence allowances, for

"If these claims be allowed, cases would arise in which a clear income from an unimpaired corpus divided between a life tenant and remainderman would entirely escape taxation."[55]

Now objection to an obsolescence claim which swallows the whole annual receipts is right and proper. Even a wasting capital asset has income-earning power so long as a bit of it remains in existence. But this admission is not enough to satisfy the anxious Secretary of the Treasury. He assumes — and perhaps the claimants of the obsolescence allowances assume — that the government is put to the narrow choice of taxing either the life tenant or nobody at all. That assumption neglects two obvious and easy victims — the trustee and the remainderman. Let us bear them in mind while we consider the case of the life tenant.

Suppose a testamentary trust fund, managed by T as trustee, with the beneficial interest so limited that R takes the income for life and X the principal free of trust on R's death. If an annuitant is subject to income tax on the ground of long-continued periodicity of payments, so it would seem is R. Besides, this situation has a double aspect which the annuity lacked. Not only has R a right to the annual output of the *res*, but the entire capital is temporarily devoted to his benefit. When X's estate first vests it is worth less than one thousand dollars, because the remainderman cannot come into possession until the life estate ends. The depreciation of X's interest would be the same even if R simply played dog-in-the-manger with the property. This was proved long ago by the parable of the slothful servant who laid away his pound in a napkin. To the remainderman's mind the life tenant's right has a nuisance

[55] Notes on the Revenue Act of 1918, part I, p. 11.

value distinct from its productive value. When we considered R as an annuitant, it was suggested that the government cannot consistently lay inheritance tax on a capitalization of his annuity and then lay income tax on the whole of each payment which he receives. But considering him as a *cestui que trust,* why may not the inheritance levy fall upon the negative or nuisance value of his estate, while the income levy falls upon the manifestation of its positive or productive power?

An argument ingenious, even if a trifle fine spun. The difficulty with it as proof that R should pay income tax is that by an easy and natural expansion it proves that X, the remainderman, should pay income tax. For the relative values of the life estate and the remainder are not constant. As the former wears itself away, there is a steady flow of new value into the latter. If X waited ten years or so after the establishment of the trust and then sold out for a fair price to a stranger with more money or more patience, he would receive substantially more than the original market worth of his interest. Has he realized a taxable gain? If so, does he not realize a greater taxable gain in case he follows the usual course of holding on until R's death and then receiving the full thousand dollars from the trustee? [56] It would be a shocking feat of double taxation to assess X on such a gain and also assess R on every cent of his receipts from T.

Where remainders were contingent and shifting, it might be harder to justify the taxation of a given remainderman for all the accessions of value caused by the absorption of the life estate. But even this would not necessitate taxation of R, if the law provided that T, the trustee, represented all remainder interests and must pay the accretion tax on them before distribution. The United States treasury has already ruled that T and not R pays taxes assessed against gains arising from successful marketing of the trust principal.[57]

On quite another theory T could be saddled with the whole income tax during the continuance of the life estate. If the donor

[56] Eisner *v.* Macomber, 252 U.S. 189 (1920), seems to call for something like a "stop" or a *realization* of income before a valid tax can be imposed on it. Seemingly there can be a valid property tax on the falling into possession and enjoyment of a vested interest. Moffit *v.* Kelly, 218 U. S. 400 (1910), and Matter of Pell, 171 N. Y. 48, 63 N. E. 789 (1902).

[57] U. S. TREAS. REGS. 45, art. 347 (a new article added in 1920).

were alive and were giving R an annual allowance out of his current receipts, D would have to meet all assessments and R would go free under the hypothesis that gifts are not taxable. Why not treat T as stepping into D's shoes and carrying on his personality for purposes of taxation? [58]

The Secretary of the Treasury in the passage cited from his Notes on the Revenue Act of 1918 adopts what we may call the external standard. If bonds, stocks, or other securities or property produce income which would be taxable to a person owning them absolutely, he seems ready to insist that the same income is equally taxable to a life tenant who receives it from the hand of a trustee. The other or internal standard would require him to break through the surface of the trust, examine the several concurrent estates or interests, and find an apportionment of actual income effected by the gradual shifting of values between the estates. This the Secretary is not prepared to do. Perhaps it is only dressing the same thought in different words to say that he overlooks or overrides the possible distinction between income *derived from a thing* — the trust *res* — and income *received by a person* — the life tenant or remainderman.

Whatever the conclusions to which these currents and cross currents may flow, enough has been said to show that in one form or another, from one person or several persons, the government is entitled under income-tax laws to levy upon the full produce of an undiminishing trust *res*. This is not the case of an annuity, where an existing capital asset is chopped to pieces and must be reconstructed a bit at a time from the fragments as they come back to the annuitant. When we deal with a trust the question is rather one of apportioning income tax between several estates than of reducing the total amount of tax. Hence the trust device rarely provides D with effective mechanism for making a gift which shall as a whole enjoy the maximum exemption. But it may enable him to make a composite gift to several persons, one or some of whom will stand comparatively tax free.

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[58] Dissenting opinion in Drummond *v.* Collins, [1914] 2 K. B. 643, 658, suggests this possibility. See s. c., [1913] 3 K. B. 583, and [1915] A. C. 1011. Confining taxes to the trustee would avoid the unjust duplicate taxation now allowed where the *cestui* is in one state and the trustee and *res* in another. Maguire *v.* Tax Commissioner, 252 U. S. (1920).

(3) *Terminable Charges upon Property*

For present purposes it seems necessary to distinguish two types of charges. D may charge a piece of property with periodical payments to R, but otherwise give X full title to and possession and enjoyment of the property; or D may create a trust, charge the *res* or its income with periodical payments to R, and forbid the trustee to relinquish the *res* to X, the remainderman, until the last of these payments has been made. A charge of the first kind falls between a terminable annuity and a terminable interest in the income of a trust fund, while in the second case R stands almost, if not quite, as if he were the "life tenant" or "tenant for years" of the trust fund. Since the taxation of this kind of "tenancy" and of the annuity have both been taken up, the reader can draw his own conclusions as to the true measure of income taxes upon charges.

(c) *Computation*

Courts are human enough to believe that figures lie less frequently than words. The man who desires to slip periodical payments past the clutches of an income tax on the argument that they are not wholly income should be prepared with an actual calculation to stand inspection and criticism. The first step in such a calculation is uniform. The payments are capitalized as of an appropriate date and the claim is made that the recipient is entitled to receive back that capital untaxed. From this point on, complication after complication must be unfolded. Do the untaxed receipts arrive first or last, or interspersed with income throughout the whole series? If the number of payments and the amount of each be certain, one may at least resort to exact mathematics. If there is uncertainty in either of these elements, the laws of probability must be invoked. If there is uncertainty in both of them, the claimant seems to swing perilously near guesswork. An actuary can always do the figuring with contemptuous ease, but a lawyer must educate himself thoroughly in the methods employed before he attempts explanations to a court.

It would, however, be an abuse of the reader's patience to attempt here any thoroughgoing discussion of calculations.[59]

[59] For a case where computation played an important part, see East Indian Railway Co. *v.* Secretary of State in Council for India, [1905] 2 K. B. 413. Henry

IV

Summary under the Hypothesis that Gifts are not Taxable as Income

The briefest summary is found in a return to our original problem. We have D wishing to make a gift to R, and to make that gift in such a form that despite its periodical nature D will pay no tax in respect of the amount donated and R will pay the least possible tax. D may succeed in creating this situation if he severs from one of his capital assets a right to future income and transfers that right to R. The only example given has been that of coupons stripped from a bond. But there are more ways than one to skin this cat. For instance, a landlord might shear from the reversion his rights under the covenant to pay rent.[60]

As to a single payment thus severed, the scanty existing authority favors a satisfactorily thoroughgoing exemption. Any break toward an unfavorable conclusion is likely to come from the contention that a payment to D's nominee is a payment to D himself. And so it is, where D thus obtains a material advantage; but not where he honestly and unqualifiedly foregoes any such advantage by making a genuine gift.[61]

Granted this step, it is next to be determined how far one can demand application of the same doctrine to periodical payments. Five years — ten years — life? There is a sharp and really dramatic collision between the rule that gifts are not taxable income, and the revenue man's concept that with few exceptions all periodical receipts *are* taxable income, particularly when the recipient pays nothing to get them. This concept of taxability has very

White Edgerton's article on "Premiums and Discounts in Trust Accounts," 31 Harv. L. Rev. 447, 455–459, 467–469, is an able discussion of a similar problem.

[60] This has been done not infrequently for other purposes. Shea *v.* McCauliff, 186 Mass. 569, 72 N. E. 69 (1904); Winnisimmet Trust, Inc. *v.* Libby, 232 Mass. 491, 122 N. E. 575 (1919).

[61] The text disregards the possibility that donated property may have appreciated or depreciated during the donor's ownership. On that point we find the ruling of the New York Comptroller: "Gifts . . . constitute a disposition of property which may result in a profit or loss." N. Y. Comptroller's Regs. (1920), art. 91. The Comptroller falls a victim to muddy thinking or muddy expression of thought. A gift does not *result* in profit or loss. It may possibly furnish a proper occasion for taxing profit or deducting loss which has accrued but never has been and never will be realized by the donor. See Professor Edward H. Warren's article in 33 Harv. L. Rev. 885.

largely triumphed in England under statutes which favor it; what it will accomplish here can be learned only from experience.

Another kind of summary is possible. The differing effects of periodical payments upon the sources from which they are drawn may burden the taxpayer's case with unfavorable presumptions or bless it with favorable ones. Presumptions are important in debatable situations. What is income to D may of course be capital to R, or *vice versa*.[62] Nevertheless there is an easily comprehensible tendency to judge the nature of a payment from what it does to the corpus which puts it forth. Where a physical subtraction from the corpus can be observed, one feels that all along the line we have a dealing with capital. Where, on the contrary, the distribution is simply from the earnings of an unimpaired fund, one draws much more easily the conclusion that the receipt is income. By and large, periodical payments may spring:

1. From a pure *chose in action*, and not from any fund of property tangible or intangible. So with a true annuity chargeable only upon the person of the obligor. Here the *chose in action* steadily shrinks, but the shrinkage is not emphatically apparent. You have to argue it out. The presumption is not particularly favorable to exemption from income tax.

2. Exclusively from the income of a fund. For example, a charge on income. Here the shrinkage of the recipient's limited interest, while real enough, is likely to be lost sight of because the capital remains an undiminished mass. Again the presumption is unfavorable.

3. Exclusively from the capital of a fund. Suppose five thousand dollars handed by D to X, not to be put on interest but to be doled out in specie to R at the rate of one thousand dollars a year. To convince a court that this is taxable income would not be easy.

4. Partly from the income and partly from the capital of a fund. Take case 3, but have X bank the money so that it earns interest; or take the very common testamentary provision which entitles the testator's widow to the income of a trust *and* so much of the

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[62] So in Delage *v.* Nugget Polish Co., Ltd., 92 L. T. (N. S.) 682 (1905), payments which were held to be capital expenditures of the defendants, and thus not deductible from their gross income, were nevertheless adjudged taxable income of the plaintiffs, who received them. MASS. RULES AND REGS. 5019, 7088, acc.

principal as the trustees deem advisable. These are strong facts for at least partial exemption from income tax.

Plainly enough, any of these so-called presumptions is rebuttable. Still taxpayers' counsel who meet those of the first and second cases will have a far harder time capturing the court's sympathy. It should also be remembered that in a given jurisdiction the first case dealing with a novel legal theory may crush the theory for all time and under all circumstances. If the facts of that case are extreme or repellant to the court's common sense, the upshot is often an unfavorable decision packed so full of emphatic language and *dicta* that it is practically impossible to employ the theory again even with different and far more appealing conditions. The clumsy legal fisherman too often muddies the water for skilled rods which follow.

V

Gifts made Taxable as Income

It would be imprudent to assume that gifts will always enjoy their present exemption from income tax. The ill starred federal act of 1894 undertook to levy upon "money and the value of all personal property acquired by gift or inheritance."[63] Where income taxes exist only by grace of constitutional amendment, more or less effective resistance to a tax on gifts may be offered upon the ground that the bare word "income" in the amendment is too narrow to justify the taxing of donations. When the average man thinks of an "income" he thinks of receipts which one has a legal right to demand, and not those which come through the good will and generosity of others.

Aside from this constitutional possibility, an interesting point may be taken with respect to gifts from foreign sources. There are on the books cases holding that if D, domiciled in state X, bequeaths to R, domiciled in state Y, property having its *situs* in X, Y may not tax the transfer even though D's executor brings the property across Y's boundary and gives it to R. For, say the courts, Y had neither personal jurisdiction over D nor jurisdiction *in rem* over his property.[64] Gift income resembles a legacy and is

[63] 53d Cong., 2d sess., c. 349, § 28; 28 Stat. at L. 553.

[64] State *v.* Brim, 57 N. C. 300 (1858); Hood's Estate, 21 Pa. St. 106 (1853); and a rather solemn warning in Tilt *v.* Kelsey, 207 U. S. 43, 60 (1907). Similar results, but different argument, in such British decisions as Hay *v.* Fairlie, 1 Russ. 117, 128 (1826).

different from income-as-of-right. A gift is a unilateral transaction, controlled as to its essence — the passage of title — only by the donor's will and the law controlling the *res*. For tangibles and specialty *choses in action*, this law is probably that of the physical *situs*; [65] for pure intangibles, probably the law of the donor's domicile.[66] The law of the donee's domicile cannot prevent the vesting of title in him; so far as our states are concerned it cannot except by way of reasonable police regulation prevent physical introduction of the article donated.[67] Conversely, it has not the slightest power to perfect or expedite the gift.

With income to which a man is legally entitled the case is distinctly different. Before the income is realized, there inheres in the recipient for at least a short time the valuable power to compel payment. His domiciliary jurisdiction by its personal control over him reaches that power of compulsion, and thus acquires a grip upon the income transaction.

Thus it seems possible that even if taxation of gifts as income is allowable, our states will not be permitted to levy upon foreign gifts. I do not suggest a similar limitation applying to the United States. The federal power to tax its citizens, whether resident or non-resident, has tremendous geographical sweep.[68] What the federal government can do to a resident alien with respect to his foreign property is possibly a shade more doubtful.[69] In this connection a distinction may also be drawn where a state seeks to tax the realization of such a gift as a life interest in the income of a foreign trust fund. Here the vesting of the donation ends its unilateral character. From then on there exists between trustee and *cestui* a bilateral relation composed of a duty on one side and a correlative right on the other. The valuable end of that relation — the right — lies in the *cestui's* jurisdiction.[70]

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[65] Green *v.* Van Buskirk, 7 Wall. (U. S.) 139 (1869). Where the transfer is by death, the law of the decedent's domicile becomes relevant.

[66] Fidelity, etc. Trust Co. *v.* Louisville, 245 U. S. 54 (1917).

[67] Rossi *v.* Pennsylvania, 238 U. S. 62, 66 (1915); U. S. Const., Art. I, § 10.

[68] It may be pushed to the extreme of a tax for exercising non-remunerative privileges in foreign jurisdictions. United States *v.* Bennett, 232 U. S. 299, 304–307 (1914); United States *v.* Goelet, 232 U. S. 293, 296 (1914).

[69] See, however, Moore *v.* Miller, 5 App. D. C. 413, 423 *et seq.* (1895); United States *v.* Erie Railway Co., 106 U. S. 327, 704 (1882).

[70] In Maguire *v.* Tax Commissioner, notes 45 and 58, *supra*, arguments were made for and against the notion that *cestui's* interest is a right of action rather than an estate. The ground of decision rendered it unnecessary to consider this point.

VI

Conclusion

I have attempted merely to suggest some possibilities of a rather curious situation. It is foolish to do more than sketch the superstructure of a legal fabric until the underpinning has been well tested. Probably few competent lawyers would be prepared to advise their clients that the exemption of gifts from income tax is founded upon the rock of constitutional privilege. But even if legislative complaisance lies at the bottom it does not follow that the rule rests upon shifting sand. Good legislative practices are often sensibly continued.

Is this particular exemption good or bad? On the whole it seems good, both for government and taxpayer. Our taxes are very severe and none too equitably adjusted.[71] Now — to take up a new metaphor — no administration can safely challenge the ingenuity of the nation's money-makers with an unyielding fiscal pack-harness. Block the fair and honest methods of easing the load where it weighs too heavily, and some clever chap will be stimulated to spill the whole thing into the ditch; or else the pack-animal may refuse to go.[72] No fairer, more honest, or more generally beneficial device for easing a galling tax could be imagined than the device of intelligent generosity. It is far better to leave this in the taxpayer's hands than to set him seeking less praiseworthy means.[73]

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[71] "Pity 't is 't is true." And perhaps it is unavoidable. "That the tax in question was exceedingly onerous is undoubted; but it may be said that there is nothing very poetical or romantic about tax laws, at best." Glasgow *v.* Rowse, 43 Mo. 479, 489 (1869).

[72] There have been sundry murmurs to this effect with the excess profits tax as the burden of their complaint.

[73] The report of the British Royal Commission on the Income Tax was not available in the United States when the foregoing text was written. Paragraphs 28, 96, 180–207, and 576 of the report bear more or less directly on the topics above discussed. See also paragraphs 290–300, covering the allowance of insurance premiums as deductions from taxable income. In a very real sense life insurance is a sinking fund for the replacement of the mortal human machine.

My comments upon the British income tax do not take into consideration the changes which have been or may be made in it as consequences of the Royal Commission's report.